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As a result of a business combination, an acquirer may consider it probable that it will recover its own deferred tax assets that were not recognized before the business combination. For example, an acquirer may be able to utilize the benefit of its unused tax losses against the future taxable profit of the acquiree. In such cases, the acquirer recognizes a deferred tax asset, but does not include it as part of the accounting for the business combination, and therefore does not take it into account in determining the goodwill or the amount of any excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination.

In addition, if the potential benefit of the acquiree's income tax loss carry–forwards or other deferred tax assets does not satisfy the criteria in IFRS 3 for separate recognition when a business combination is initially accounted for, but is subsequently realized, the acquirer will recognize the resulting deferred tax income in profit or loss. In addition, the acquirer must:

- reduce the carrying amount of goodwill to the amount that would have been recognized if the deferred tax asset had been recognized as an identifiable asset from the acquisition date; and
- recognize the reduction in the carrying amount of goodwill as an expense.

If any deferred tax assets related to the merger with Lucent are recognized in future financial statements of the combined company, the impact will be accounted for in the statement of income (for the tax losses not yet recognized related to both former Alcatel and Lucent entities), but the goodwill will be reduced accordingly (for the tax losses related to former Lucent entities only).

Amounts of reduction of goodwill already accounted for in the purchase price allocation related to the acquisition of Lucent are disclosed in Note 9.

(o) Revenues

Revenues include net sales and service revenues from the Group's principal business activities, net of value added taxes (VAT) and income due from licensing fees and from income grants, net of VAT.

Most of the Group's sales are generated from complex contractual arrangements that require significant revenue recognition judgments, particularly in the areas of the sale of goods and equipment with related services constituting multiple–element arrangements, construction contract accounting, the application of software revenue recognition rules, and the assessment of collectibility.

Revenues from the sale of goods and equipment are recognized when persuasive evidence of an arrangement with the customer exists, delivery has occurred, and the significant risks and rewards of ownership of a product have been transferred to the customer, the amount of revenue can be measured reliably and it is probable that the economic benefits associated with the transaction will flow to the Group. For arrangements where the customer specifies formal acceptance of the goods, equipment, services or software, revenue is generally deferred until all the acceptance criteria have been met.

Revenues from contracts with multiple–element arrangements, such as those including products with installation and integration services, are recognized as the revenue for each unit of accounting is earned based on the relative fair value of each unit of accounting as determined by internal or third–party analyses of market–based prices. A delivered element is considered a separate unit of accounting, if it has value to the customer on a standalone basis, there is objective and reliable evidence of the fair value of the undelivered elements in the arrangement, and delivery or performance of the undelivered elements is considered probable and substantially under the Group's control. If these criteria are not met, revenue for the arrangement as a whole is accounted for as a single unit of accounting in accordance with the criteria described in the preceding paragraph.

Under IAS 11, construction contracts are defined as contracts specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose of use (primarily those related to customized network solutions and network build–outs with a duration of more than two quarters). For revenues generated from construction contracts, the Group applies the percentage of completion method of accounting in application of the above principles, provided certain specified conditions are met, based either on the achievement of contractually defined milestones or on costs incurred compared with total estimated costs. Any probable construction contract losses are recognized immediately in cost of sales. If uncertainty exists regarding customer acceptance, or the contract's duration is relatively short, revenues are recognized only to the extent of costs incurred that are recoverable, or on completion of the contract. Work in progress on construction contracts is stated at production cost, excluding administrative and selling expenses. Changes in provisions for penalties for delayed delivery or poor contract execution are reported in revenues and not in cost of sales.

Advance payments received on construction contracts, before corresponding work has been carried out, are recorded in customers' deposits and advances. Costs incurred to date plus recognized profits less the sum of recognized losses (in the case of provisions for contract losses) and progress billings, are determined on a contract–by–contract basis. If the amount is positive, it is included as an asset under "amount due from customers on construction contracts". If the amount is negative, it is included as a liability under "amount due to customers on construction contracts".

Software revenue recognition rules (as prescribed by the AICPA's SOP 97–2) are applied for revenues generated from licensing, selling or otherwise marketing software solutions when the software is sold on a standalone basis, or when the software is embedded with the Group's hardware and the software is considered more than incidental. In multiple–element arrangements, where software is considered more than incidental, the fair value of an undelivered element is determined using vendor–specific objective evidence (VSOE) of fair value. If VSOE of fair value cannot be determined or any undelivered element is essential to the functionality of the delivered element, revenue is deferred until either such criteria are met or the last element is delivered, or revenue is deferred and recognized ratably over the service period.

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For arrangements to sell services only, revenue from training or consulting services is recognized when the services are performed. Maintenance service revenue, including post-contract customer support, is deferred and recognized ratably over the contracted service period. Revenue from other services is generally recognized at the time of performance.

For product sales made through retailers and distributors, assuming all other revenue recognition criteria have been met, revenue is recognized upon shipment to the distribution channel, if such sales are not contingent on the distributor selling the product to third parties and the distribution contracts contain no right of return. Otherwise, revenue is recognized when the reseller or distributor sells the product to the end user.

Product rebates or quantity discounts are deducted from revenues with the exception of promotional activities giving rise to free products, which are accounted for in cost of sales and provided for in accordance with IAS 37 "Provisions, Contingent Liabilities and Contingent Assets", or IAS 11 "Construction Contracts". The accounting treatment of free products could be amended in the future depending upon the final IFRIC determination related to customer loyalty programs. The Group accrues warranty costs, sales returns and other allowances based on contract terms and its historical experience.

Revenue in general is measured at the fair value of the consideration received or to be received. Where a deferred payment has a significant impact on the calculation of fair value, it is accounted for by discounting future payments.

The assessment of collectibility is critical in determining whether revenue or expense should be recognized. As part of the revenue recognition process, the Group assesses whether it is probable that economic benefits associated with the transaction will flow to the Group. If the Group is uncertain as to whether economic benefits will flow to the Group, revenue is deferred and recognized on a cash basis. However, if uncertainty arises about the collectibility of an amount already included in revenue, the amount in respect of which recovery has ceased to be probable is recognized as an expense in "cost of sales".

(p) Income (loss) from operating activities before restructuring costs, impairment of intangible assets and gain/(loss) on disposal of consolidated entities and Income (loss) from operating activities

Alcatel–Lucent has considered it relevant to the understanding of the company's financial performance to present on the face of the income statement a subtotal inside the income (loss) from operating activities.

This subtotal, named "Income (loss) from operating activities before restructuring costs, impairment of intangible assets and gain/(loss) on disposal of consolidated entities", excludes those elements that have little predictive value due to their nature, frequency and/or materiality.

Those elements can be divided in two categories:

- Elements that are both very infrequent and material, such as a major impairment of an asset (for example, the impairments of intangible assets accounted for in 2004 and 2006 following the Group's decision to stop specific product lines or resulting from material changes in their recoverable value), a disposal of investments (such as the capital gain related to the Space business accounted for in 2005) or the settlement of litigation having a material impact;
- Elements that are by nature unpredictable in their amount and/or in their frequency, if they are material. Alcatel–Lucent considers that materiality must be assessed not only by comparing the amount concerned with the income (loss) from operating activities of the period, but also in terms of changes in the item from one period to the other. For example, restructuring charges have shown dramatic changes from one period to the other.

Share–based payments were also isolated in 2005 and 2004 due to the fact that this type of expense was not yet recognized in other generally accepted accounting standards used by some of the Group's main competitors. In view of the relative lack of materiality of these payments and the evolution of other accounting standards toward the same principle as is applied under IFRS, Alcatel–Lucent has decided to discontinue this presentation beginning with fiscal 2006. As a result, share–based payments are no longer isolated, but are allocated by function. Income statements for the prior periods (i.e. 2004 and 2005) have been conformed to the current period presentation.

Income (loss) from operating activities includes gross margin, administrative and selling expenses and research and development costs (see Note 1f) and, in particular, pension costs (except for the financial component, see Note 1k), employee profit sharing, fair value changes of derivative instruments related to commercial bids, valuation allowances on receivables (including the two categories of vendor financing as described in Note 1v) and capital gains (losses) from the disposal of intangible assets and property, plant and equipment, and all other operating expenses or income regardless of their predictive value in terms of nature, frequency and/or materiality.

Income (loss) from operating activities is calculated before financial income (loss), which includes the financial component of retirement expenses, financing costs and capital gains (losses) from disposal of financial assets (shares in a non–consolidated company or company consolidated under the equity method and other non–current financial assets, net), and before reduction of goodwill related to realized unrecognized tax loss carry forwards income tax, share in net income (losses) of equity affiliates and income (loss) from discontinued operations.

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(q) Finance costs

This item includes interest charges and interest income relating to net consolidated debt, which consists of bonds, the liability component of compound financial instruments such as OCEANE and other convertible bonds, other long–term debt (including lease–financing liabilities), and all cash assimilated items (cash, cash equivalents and marketable securities).

Borrowing costs that are directly attributable to the acquisition, construction or production of an asset are capitalized as part of the cost of that asset.

(r) Structure of consolidated balance sheet

Most of the Group's activities in the various business segments have long–term operating cycles. As a result, the consolidated balance sheet combines current assets (including other inventories and work in progress and trade receivables and related accounts) and current liabilities (including other provisions, customers' deposits and advances, trade payables and related accounts) without distinction between the amounts due within one year and those due after one year.

(s) Financial instruments and derecognition of financial assets

Financial instruments

The Group uses financial instruments to manage and reduce its exposure to fluctuations in interest rates and foreign currency exchange rates.

The accounting policies applied to currency hedge–related instruments are detailed in Note 1e.

Financial instruments for interest rate hedges are subject to fair value hedge accounting. Financial liabilities hedged using interest rate swaps are measured at the fair value of the obligation linked to interest rate movements. Fair value changes are recorded in the income statement for the year and are offset by equivalent changes in the interest rate swaps for the effective part of the hedge.

Derecognition of financial assets

A financial asset as defined under IAS 32 "Financial Instruments: Disclosure and Presentation" is either totally or partially derecognized (removed from the balance sheet) when the Group expects no further cash flow to be generated by it and retains no control of the asset or transfers substantially all risks and rewards attached to it.

In the case of trade receivables, a transfer without recourse in case of payment default by the debtor is regarded as a transfer of substantially all risks and rewards of ownership, thus making such receivables eligible for derecognition, on the basis that risk of late payment is considered marginal. A more restrictive interpretation of the concept of "substantial transfer of risks and rewards" could put into question the accounting treatment that has been adopted.

The amount of receivables sold without recourse is given in Note 18.

(t) Cash and cash equivalents

In accordance with IAS 7 "Cash Flow Statements", cash and cash equivalents in the consolidated statements of cash flows includes cash (cash funds and term deposits) and cash equivalents (short–term investments that are very liquid and readily convertible to known amounts of cash and are only subject to negligible changes of value). Cash and cash equivalents in the statement of cash flows does not include investments in listed securities, investments with an initial maturity date exceeding three months and without an early exit clause, or bank accounts restricted in use, other than restrictions due to regulations applied in a specific country or sector of activities (exchange controls, etc.).

Bank overdrafts are considered as financing and are also excluded from cash and cash equivalents.

Cash and cash equivalents in the balance sheet correspond to the cash and cash equivalents defined above.

(u) Marketable securities

Marketable securities are quoted market funds with original maturities exceeding three months and/or with underlying assets such as listed shares. In accordance with IAS 39 "Financial Instruments: Recognition and Measurement", marketable securities are valued at their fair value. No securities are classified as "held–to–maturity". For securities designated as financial assets at fair value through profit or loss, changes in fair value are recorded in the income statement (in other financial income (loss)). For available–for–sale securities, changes in fair value are recorded in shareholders' equity, or in the income statement (other financial income (loss)), if there is objective evidence of a more than temporary decline in the fair value, or in connection with a disposal of such securities.

Further to the publication of the "Fair Value Option" amendment to IAS 39 "Financial Instruments: Recognition and Measurement", effective from January 1, 2006, certain marketable securities previously included in the category of financial assets at fair value through profit or loss are now designated as financial assets available for sale. The impact of this change, had it been applied in 2005 and 2004, is presented in Note 8—Financial income (loss) and in the consolidated statement of changes in shareholders' equity.

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(v) Customer financing

The Group undertakes two types of customer financing:

- financing relating to the operating cycle and directly linked to actual contracts;
- longer-term financing (beyond the operating cycle) through customer loans, minority investments or other forms of financing.

The first category of financing is accounted for in "Other current or non current assets, net".

The second category of financing is also accounted for in "Other current or non-current assets, net". The second category was previously presented (that is, before December 31, 2006) in "Other non-current financial assets, net". Changes in these two categories of assets are included in cash flows from operating activities in the consolidated statement of cash flows. Changes in the second category were previously presented (that is, before December 31, 2006) in cash flows from investing activities in the consolidated statement of cash flows and is now presented on the line item "decrease (increase) in vendor financing loans" in cash flows from operating activities.

Furthermore, the Group may give guarantees to banks in connection with customer financing. These are included in off balance sheet commitments.

(w) Stock options

In accordance with the requirements of IFRS 2 "Share-based Payment", stock options granted to employees are included in the financial statements using the following principles: the stock option's fair value, which is considered to be a reflection of the fair value of the services provided by the employee in exchange for the option, is determined on the grant date. It is accounted for in additional paid-in capital (credit) at grant date, with a counterpart in deferred compensation (debit) (also included in additional paid-in capital). During the vesting period, deferred compensation is amortized in the income statement.

Stock option fair value is calculated using the Cox-Ross-Rubinstein binomial model. This model permits to take into consideration the option's characteristics, such as exercise price and expiry date, market data at the time of acquisition, such as the interest rate on risk-free securities, share price, volatility and expected dividends, and behavioral factors of the beneficiary, such as expected early exercise.

Only options issued after November 7, 2002 and not fully vested at January 1, 2005 and those issued after January 1, 2005 are accounted for according to IFRS 2.

The impact of applying IFRS 2 on net income (loss) is accounted for in "cost of sales", "research and development costs" or "administrative and selling expenses" depending on the functions of the beneficiaries. As this impact had been accounted for in a specific line item ("share-based payments") in the consolidated income statements published before December 31, 2006, income statements related to prior periods presented (2004 and 2005) have been conformed to the current period presentation.

Outstanding stock options at the acquisition date of a company acquired by Alcatel-Lucent in a business combination are usually converted into options to purchase Alcatel-Lucent shares using the same exchange ratio as for the acquired shares of the target company. In accordance with IFRS 3 "Business Combinations" and IFRS 2 "Share-based Payment" requirements, the fair value of stock options acquired at the time of acquisition is accounted for in the caption "additional paid-in capital". Unvested options at the acquisition date are accounted for at their fair value as deferred compensation in shareholders' equity (included in additional paid-in capital). The sum of these two amounts, equivalent to the fair value of vested options, is taken into account in the cost of the business combination.

Only acquisitions made after January 1, 2004 and for which unvested stock options as of December 31, 2004 existed at the acquisition date are accounted for as described above.

(x) Assets held for sale and discontinued operations

A non-current asset or disposal group (group of assets or a cash generating unit) to be sold is considered as held for sale if its carrying amount will be recovered through a sale transaction rather than through continuing use. For this to be the case, the asset must be available for sale and its sale must be highly probable. These assets or disposal groups classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell.

A discontinued operation is a separate major line of business or geographical area of operations for the Group that is either being sold or is being held for sale. The net income (loss) and statement of cash flow elements relating to such discontinued operations are presented in specific captions in the consolidated financial statements for all periods presented.

(y) Accounting standards and interpretations that have been published but are not yet effective

As of December 31, 2006, there were no IFRS accounting standards and interpretations that had been published but were not yet effective, which have been applied by Alcatel-Lucent earlier than the effective date. Other IFRS accounting standards and interpretations that have been published by the approval date of these financial statements but are not yet effective and for which the Group has not elected early application and that are likely to affect the Group are as follows:

- IFRS 7 "Financial Instruments—Disclosures", effective for annual periods beginning on or after January 1, 2007;

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- IAS 1 "Amendment relating to Capital Disclosures", effective for annual periods beginning on or after January 1, 2007;
- IFRIC 8 scope of IFRS 2: effective for annual periods beginning on or after May 1, 2006; and
- IFRIC 9 "Reassessment of Embedded Derivatives", effective for annual periods beginning on or after June 1, 2006.

The Group is currently assessing the potential impact that application of these standards and interpretations will have on consolidated net income (loss), financial position, changes in cash and cash equivalents and notes to the consolidated financial statements. At this stage, Alcatel–Lucent does not anticipate any significant impact on the Group's financial condition, results of operations and cash flows.

Note 2 – Principal uncertainties regarding the use of estimates

The preparation of consolidated financial statements in accordance with IFRSs requires that the Group make a certain number of estimates and assumptions that are considered realistic and reasonable. However, subsequent facts and circumstances could lead to changes in these estimates or assumptions, which would affect the Group's financial condition, results of operations and cash flows.

(a) Valuation allowance for inventories and work in progress

Inventories and work in progress are measured at the lower of cost or net realizable value. Valuation allowances for inventories and work in progress are calculated based on an analysis of foreseeable changes in demand, technology or the market, in order to determine obsolete or excess inventories and work in progress.

The valuation allowances are accounted for in cost of sales or in restructuring costs depending on the nature of the amounts concerned.

The impact of inventory and work in progress write–down on Alcatel–Lucent income before tax was a net charge of €77 million in 2006 (a net charge of €18 million in 2005 and a net gain of €20 million in 2004), representing new write–down taken in 2006 which more than offset the reversal of existing provisions of €98 million due to asset sales that occurred in 2006.

(b) Impairment of customer receivables and loans

An impairment loss is recorded for customer receivables and loans if the present value of the future receipts is below the nominal value. The amount of the impairment loss reflects both the customers' ability to honor their debts and the age of the debts in question. A higher default rate than estimated or the deterioration of Alcatel–Lucent major customers' creditworthiness could have an adverse impact on Alcatel–Lucent future results. Impairment losses on customer receivables were €192 million at December 31, 2006 (€228 million at December 31, 2005 and €284 million at December 31, 2004). The impact of impairment losses on customer receivables on income (loss) before tax, related reduction of goodwill and discontinued operations was a net charge of €18 million in 2006 (a net gain of €19 million in 2005 and €43 million in 2004).

Impairment losses on customer loans and other financial assets (assets essentially relating to customer financing arrangements) were €838 million at December 31, 2006 (€897 million at December 31, 2005 and €908 million at December 31, 2004). The impact of these impairment losses on income before tax related reduction of goodwill and discontinued operations was a net gain of €2 million in 2006 (a net gain of €25 million in 2005 and a net gain of €77 million in 2004).

(c) Goodwill, capitalized development costs, and other intangible assets

Capitalized development costs

The criteria for capitalizing development costs are set out in Note 1f. Once capitalized, these costs are amortized over the estimated lives of the products concerned.

The Group must therefore evaluate the commercial and technical feasibility of these development projects and estimate the useful lives of the products resulting from the projects. Should a product fail to substantiate these assumptions, the Group may be required to impair or write off some of the capitalized development costs in the future.

An impairment loss of €104 million and write offs amounting to €197 million have been accounted for in capitalized development costs in 2006, and are mainly related to discontinuance of product lines following the acquisition of UMTS technologies from Nortel and the business combination with Lucent (refer to Notes 3, 7 and 13).

Goodwill and intangible assets

Goodwill amounting to €8,051 million and intangible assets amounting to €4,813 million were accounted for in 2006 as a result of the Lucent business combination as described in Note 3. Using market–related information, estimates (primarily based on risk adjusted discounted cash flows) and judgment, an independent appraiser determined the preliminary fair values of the net assets acquired from Lucent, and in particular those relating to the intangible assets acquired. If the expected results of the acquired business in the future do not support such fair values and the goodwill resulting from the business combination, impairment charges against such intangible assets and goodwill may be required in future financial statements. Goodwill and intangible assets related to the Lucent transaction are preliminary and subject to change.

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An impairment loss of €40 million and write–offs amounting to €233 million have been accounted against intangible assets in 2006, mainly related to discontinued product lines following the acquisition of UMTS technologies from Nortel and the business combination with Lucent (refer to Notes 3, 7 and 13).

As indicated in Note 1g, in addition to the annual goodwill impairment tests, timely impairment tests are carried out in the event of indications of reduction in value of intangible assets held. Possible impairments are based on discounted future cash flows and/or fair values of the assets concerned. A change in the market conditions or the cash flows initially estimated can therefore lead to a review and a change in the impairment loss previously recorded.

Net goodwill is €10,977 million at December 31, 2006 (€3,772 million at December 31, 2005 and €3,774 million at December 31, 2004). Other intangible assets, net were €5,347 at December 31, 2006 (€819 million at December 31, 2005 and €705 million at December 31, 2004)

(d) Impairment of property, plant and equipment

In accordance with IAS 36 *Impairment of Assets*, when events or changes in market conditions indicate that tangible or intangible assets may be impaired, such assets are reviewed in detail to determine whether their carrying value is lower than their recoverable value, which could lead to recording an impairment loss (recoverable value is the higher of its value in use and its fair value less costs to sell) (see Note 1g). Value in use is estimated by calculating the present value of the future cash flows expected to be derived from the asset. Fair value less costs to sell is based on the most reliable information available (market statistics, recent transactions, etc.).

The planned closing of certain facilities, additional reductions in personnel and reductions in market outlooks have been considered impairment triggering events in prior years. No significant impairment losses were recorded in 2006, 2005 and 2004.

When determining recoverable value of property, plant and equipment, assumptions and estimates are made, based primarily on market outlooks, obsolescence and sale or liquidation disposal values. Any change in these assumptions can have a significant effect on the recoverable amount and could lead to a revision of recorded impairment losses.

(e) Provision for warranty costs and other product sales reserves

Provisions are recorded for (i) warranties given to customers on Alcatel–Lucent products, (ii) expected losses and (iii) penalties incurred in the event of failure to meet contractual obligations on construction contracts. These provisions are calculated based on historical return rates and warranty costs expensed as well as on estimates. These provisions and subsequent changes to the provisions are recorded in cost of sales either when revenue is recognized (provision for customer warranties) or, for construction contracts, when revenue and expenses are recognized by reference to the stage of completion of the contract activity. Costs and penalties that eventually will be paid can differ considerably from the amounts initially reserved and could therefore have a significant impact on future results.

Product sales reserves represented €670 million at December 31, 2006, of which €71 million related to construction contracts (see Note 18) (€753 million at December 31, 2005, of which €173 million related to construction contracts and €933 million and €271 million respectively at December 31, 2004). For further information on the impact on 2006 income (loss) from operating activities before restructuring costs, impairment of intangible assets and gain/(loss) on disposal of consolidated entities of the change in these provisions, see Notes 18 and 27.

(f) Deferred taxes

Deferred tax assets relate primarily to tax loss carry forwards and to deductible temporary differences between reported amounts and the taxes bases of assets and liabilities. The assets relating to the tax loss carry forwards are recognized if it is probable that the Group will generate future taxable profits against which these tax losses can be set off.

At December 31, 2006, deferred tax assets were €1,692 million of which €746 million relate to the United States and €372 million to France (€1,606 million at December 31, 2005, of which €850 related to the United States and €369 million to France). Evaluation of the Group's capacity to utilize tax loss carry forwards relies on significant judgment. The Group analyzes the positive and negative elements of certain economic factors that may affect the Group's business in the foreseeable future and past events to conclude as to the probability of utilization in the future of these tax loss carry forwards, which also consider the factors indicated in Note 1n. This analysis is carried out regularly in each tax jurisdiction where significant deferred tax assets are recorded.

If future taxable results are considerably different from those forecast that support recording deferred tax assets, the Group will be obliged to revise downwards or upwards the amount of the deferred tax assets, which would have a significant impact on Alcatel–Lucent balance sheet and net income (loss).

As a result of the business combination with Lucent, €2,405 million of net deferred tax liabilities have been recorded resulting from the temporary differences generated by the differences between the fair valuation of assets and liabilities acquired (mainly intangible assets such as acquired technologies) and their corresponding tax bases. These deferred tax liabilities will be reversed in the future Group's statements of income as and when such differences are amortized.

As prescribed by IFRS, Alcatel–Lucent has a twelve–month period to complete the purchase price allocation and to determine whether certain deferred tax assets related to the carry–forward of Lucent's unused tax losses that have not been recognized in Lucent's historical financial statements should be recognized in the financial statements of the combined company. If any deferred tax assets related to the business combination (resulting from Lucent's unrecognized tax losses) are recorded in future financial statements of the combined company, the impact will be accounted for (as income) in the statement of income. However, in addition, goodwill will be reduced (resulting in an expense) for that part of the losses recognized relating to Lucent's tax losses.

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On the other hand, subsidiaries of historical Alcatel may consider that, as a result of a business combination with Lucent, it is probable that they will recover their own tax losses not recognized as a deferred tax asset before the business combination. For example, an entity may be able to utilize the benefit of its own unused tax losses against the future taxable profit of the Lucent business. In such cases, Alcatel–Lucent would recognize a deferred tax asset but does not include it as part of the accounting for the business combination. It could therefore have a positive impact on Alcatel–Lucent future net results.

(g) Pension and retirement obligations and other employee and post–employment benefit obligations

Due to the business combination with Lucent, Alcatel–Lucent results of operations include the impact of significant pension and post–retirement benefits that are measured using actuarial valuations. Inherent in these valuations are key assumptions, including assumptions about discount rates, expected return on plan assets and expected participation rates in retirement health care plans. These assumptions are updated on an annual basis at the beginning of each fiscal year or more frequently upon the occurrence of significant events. Changes in the related pension and post–retirement benefit costs or credits may occur in the future due to changes in the assumptions. The net effect of pension and post–retirement cost included in Alcatel–Lucent income (loss) before tax related reduction of goodwill and discontinued operations was €120 million, €93 million and €104 million during fiscal 2006, 2005 and 2004, respectively.

The weighted average expected rate of return on pension plan assets used to develop Alcatel–Lucent pension credit was 7.35% (computed on a yearly basis including businesses acquired during the year), 4.28% and 4.70% during fiscal 2006, 2005 and 2004, respectively, and is determined at the beginning of the period. Alcatel–Lucent plans to use an expected rate of return of 7.25% during fiscal 2007. Changes in the rate were generally due to different expected future returns based on studies performed by Alcatel–Lucent external investment advisors or to a change of the asset allocation. Similar changes were made to Alcatel–Lucent expected rate of return on post–retirement plan assets due to lower expected future returns, as well as for changes in the mix of assets held. A lower expected rate of return reduces Alcatel–Lucent net pension result and profitability.

The weighted average discount rate used to determine the pension credit was 3.98% for Alcatel and its subsidiaries and 5.44% for Lucent and its subsidiaries, each prior to the business combination in 2006 and 4.46% and 4.81% during fiscal 2005 and 2004, respectively. The discount rate is determined at the beginning of the period. Alcatel–Lucent plans to use a weighted average discount rate of 5.54% during fiscal 2007. Changes in the discount rate were due to increasing long–term interest rates during 2006. The discount rate is also somewhat volatile because it is determined based upon the prevailing rate as of the measurement date. Similar adjustments were made to the discount rate used to determine Alcatel–Lucent post–retirement benefit costs. The discount rate used to determine the post–retirement benefit costs is slightly lower due to a shorter expected duration of post–retirement plan obligations as compared to pension plan obligations. A lower discount rate increases the plan obligations and reduces Alcatel–Lucent net pension credit and profitability for those plans where actuarial losses are being amortized. Otherwise, a higher discount rate increases Alcatel–Lucent net pension credit and profitability.

The expected rate of return on pension plan assets and the discount rate as well as the amortization of unrecognized actuarial gains and losses were determined in accordance with consistent methodologies, as described in Note 1k.

Holding all other assumptions constant, a 0.5% increase or decrease in the discount rate would have increased/decreased the fiscal 2006 net pension result by approximately €28 million and €20 million, respectively. The impact of changes in the discount rate is different if the resulting actuarial gains or losses are subject to amortization. A 0.5% increase or decrease in the expected return on plan assets would have increased or decreased the fiscal 2006 net pension result by approximately €35 million.

In the U.S., there have been several recent developments related to retiree health care benefits, including changes in benefits, cost sharing and legislation, such as Medicare Part D of the Medicare Prescription Drug Improvement and Modernization Act of 2003.

Lucent has taken various actions to reduce its share of retiree health care costs during recent periods, including the shifting of certain costs to its retirees. Lucent's retiree health care obligations are determined using the terms of the current plans, under which health care benefits for employees who retired prior to March 1, 1990 are not subject to annual dollar caps on the Lucent's share of future benefit costs. The benefit obligation associated with this retiree group approximated 60% of Lucent total retiree health care obligation. Management employees who retired on or after March 1, 1990 have paid premiums above the applicable annual dollar caps on Lucent's share of future benefits costs. since 2001 Lucent's collective bargaining agreements were ratified during December 2004 and address retiree health care benefits, among other items. Lucent agreed to continue to subsidize these benefits up to the established cap level consistent with Lucent's current actuarial assumptions. Except for costs attributable to an implementation period that ended on February 1, 2005, costs that are in excess of this capped level are being borne by the retirees in the form of premiums and plan design changes. Lucent also agreed to establish a new U.S. $400 million trust to be funded over eight years and managed jointly by trustees appointed by Lucent and the unions, U.S. $50 million of which has been contributed and U.S. $25 million of which has been provided for through a Section 420 transfer. The remaining U.S. $325 million of contributions to the trust, which may be funded in Lucent's discretion either from operating cash or excess pension assets, would be required if the conditions described in the risk factor in Item 3 above (concerning Lucent's pension and post–retirement benefit plans) are achieved.The trust is being used to mitigate the cost impact on retirees of premiums or plan design changes. The agreements also acknowledge that retiree health care benefits will no longer be a subject of bargaining between the Lucent and the unions.

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Under IFRS, the amount of prepaid pension costs that can be recognized in the financial statements is limited to the sum of the cumulative unrecognized net actuarial losses and past service cost, the present value of any available refunds from the plan, and any reduction in future contributions to the plan. As Lucent currently has the ability and intent to use eligible excess pension assets to fund certain retiree healthcare benefits for formerly represented retirees, such use has been considered as a refund from the related plans. The funded status of the formerly represented retiree health care obligation of approximately €(1.9) billion, the present value of Medicare Part D subsidies of approximately €360 million (as this amount is currently netted in the retiree health care obligation) and the present value of future service costs of €182 million have been considered in determining the asset ceiling limitation for Lucent's pension plans as of December 31, 2006.

The expected future economic benefits related to pension plan assets in determining the asset ceiling is a complex matter. As of the January 1, 2007 valuation date, there were approximately €1.6 billion of pension plan assets that would be eligible for "collectively bargained" transfers to fund retiree health care costs for Lucent formerly represented retirees (alternatively, €1.2 billion would be available for conventional transfers). Lucent have assumed that the eligible plan assets will increase over time through the 2013 expiration date of the current legislation and as a result Lucent will be able to utilize more pension plan assets for Section 420 transfers that are currently available as of December 31, 2006. Changes in plan asset values, funding levels or legislation could result in significant changes in the asset ceiling. This could result in significant volatility in the results of operations or a reduction in the pension credit that could be recognized in the results of operations. The pension credit related to Lucent's occupational pension plans was reduced by €61 million during the month ended December 31, 2006, due to this asset ceiling.

(h) Revenue recognition

As indicated in Note 1o, revenue is measured at the fair value of the consideration received or to be received when the Group has transferred the significant risks and rewards of ownership of a product to the buyer.

For revenues and expenses generated from construction contracts, the Group applies the percentage of completion method of accounting, provided certain specified conditions are met, based either on the achievement of contractually defined milestones or on costs incurred compared with total estimated costs. The determination of the stage of completion and the revenues to be recognized rely on numerous estimations based on costs incurred and acquired experience. Adjustments of initial estimates can, however, occur throughout the life of the contract, which can have significant impacts on future net income (loss).

For arrangements to sell software licenses with services, software license revenue is recognized separately from the related service revenue, provided the transaction adheres to certain criteria (as prescribed by the Statement of Position (SOP) 97−2) of the American Institute of Certified Public Accountants or the AICPA's, such as the existence of sufficient vendor−specific objective evidence ("VSOE") to determine the fair value of the various elements of the arrangement.

Some of the Group's products include software that is embedded in the hardware at delivery. In those cases, where indications are that software is more than incidental, such as where the transaction includes software upgrades or enhancements, software revenue recognition rules are applied to determine the amount and timing of revenue recognition. As products with embedded software are continually evolving, as well as the features and functionality of the product driven by software components that are becoming more critical to their operation and success in the market, the Group is continually assessing the applicability of SOP 97−2 including whether software is more than incidental. Several factors are considered in making this determination including (i) whether the software is a significant focus of the marketing effort or is sold separately, (ii) whether updates, upgrades and other support services are provided on the software component and (iii) whether the costs to develop the software component of the product is significant in relation to the costs to develop the product as a whole. The determination of whether the evolution of our products and marketing efforts should result in the application of SOP 97−2 requires the use of significant professional judgment. Further, the Group believes that reasonable people evaluating similar facts and circumstances may come to different conclusions regarding the most appropriate accounting model to apply in the environment particularly if VSOE can be obtained. Our future results of operations may be significantly impacted, particularly due to the timing of revenue recognition if we change our assessment as to whether software is incidental.

For product sales made through distributors, product returns that are estimated according to contractual obligations and past sales statistics are recognized as a reduction of sales if the actual product returns were considerably different from those estimated, the resulting impact on the income statement could be significant.

It can be difficult to evaluate the Group's capacity to recover receivables. Such evaluation is based on the customers' creditworthiness and on the Group's capacity to sell such receivables without recourse. If, subsequent to revenue recognition, the recoverability of a receivable that had been initially considered as likely becomes doubtful, a provision for an impairment loss is then recorded (see Note 2b above).

Note 3 − Changes in consolidated companies

The main changes in consolidated companies for 2006 were as follows:

- On January 27 2006, Alcatel acquired a 27.5% stake in 2Wire, a pioneer in home broadband network solutions, for a purchase price of US$122 million in cash. This company is consolidated under the equity method and its contribution to Alcatel−Lucent's 2006 net income is not significant. Goodwill accounted for in share of net assets of equity affiliates as of December 31, 2006 amounted to €37 million.
- On April 2, 2006, Alcatel and Lucent Technologies, Inc. ("Lucent") announced that they had entered into a definitive merger agreement. Completion of the merger was announced on November 30, 2006 and Lucent became a wholly owned subsidiary. As a result, Alcatel, the parent company, changed its name to Alcatel−Lucent.

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Under the terms of the agreement, Lucent shareholders received 0.1952 of an ADS (American Depositary Share) representing ordinary shares of Alcatel–Lucent for every common share of Lucent that they held, which resulted in the issuance of 878 million shares at a stock price of €10.16 (Alcatel's closing share price on Euronext as of November 29, 2006).

Alcatel–Lucent remains headquartered in Paris, although its North American operations are based in New Jersey, U.S.A. Bell Labs remains headquartered in New Jersey. The Board of Directors of Alcatel–Lucent is composed of 14 members and has equal representation from each company, including Serge Tchuruk and Patricia Russo, five of Alcatel's former directors and five of Lucent's former directors. The board also includes two new independent European directors who were mutually agreed upon.

Alcatel–Lucent has formed a specific U.S. subsidiary to hold certain contracts with U.S. government agencies and is subject to reinforced confidentiality and security conditions. This company has a Board of Directors comprised of three individuals who have no prior relationship with Alcatel–Lucent, except as otherwise allowed by the US Department of Defense.

The cost of the business combination is detailed in the following table:

Number of Lucent common shares outstanding as of November 30, 2006	4,498,666,060
Exchange ratio per share (1,952 Alcatel–Lucent ordinary shares exchanged for 10,000 Lucent ordinary shares tendered)	0.1952
Total number of Alcatel–Lucent ordinary shares issued	**878,139,615**
Multiplied by Alcatel–Lucent's stock price *(in euros)* as of the effective date	10.16
Fair value of Alcatel–Lucent ordinary shares issued *(in millions of euros)*	8,922
Fair value of the issuable equity instruments relating to Lucent's compound financial instruments	761
Fair value of outstanding warrants	35
Fair value of outstanding stock–options and similar equity awards	133
Transaction costs	40
Cost of the business combination *(in millions of euros)*	**9,891**

The number of issuable equity instruments assumed in connection with this business combination is as follows:

- Issuable ordinary shares related to Lucent's compound financial instruments: 159,371,932;
- Issuable ordinary shares related to outstanding Lucent's stock options and similar equity awards: 60,767,243;
- Issuable ordinary shares related to outstanding Lucent's warrants: 38,907,871.

The fair value of the outstanding stock options and similar instruments has been determined as prescribed by IFRS 2 – Share–based Payment and as described in Note 1w above.

The fair value of the issuable equity instruments related to Lucent's compound financial instruments corresponds to the equity component amount of such instruments. The equity component has been computed as described in Note 1m.

Under the purchase method, Alcatel–Lucent allocated the purchase price to tangible assets, liabilities assumed, and intangible assets, based on their estimated fair values. The excess of the purchase price over Alcatel's interest (as the acquirer) in the net fair value of Lucent's (as the acquiree) identifiable assets and liabilities was recorded as goodwill.

The fair value assigned to intangible assets acquired is determined using the income approach, which discounts expected future cash flows to present value using estimates and assumptions determined by management. Purchased intangible assets are amortized on a straight–line basis over their respective useful lives.

The cost of the business combination was allocated using the information currently available. As a result, Alcatel–Lucent may continue to adjust the preliminary purchase price allocation upon obtaining more information regarding, among other things, asset valuations, liabilities and contingent liabilities assumed, and revisions of preliminary estimates, in particular as they relate to the determination of the fair value of acquired intangible assets. Consequently, the purchase price allocation will be finalized in 2007.

The factors that contributed to a cost that results in the recognition of goodwill are primarily the asset ceiling impact related to pension obligations (refer to Note 25d) for an amount of €1,732 million and the fact that no deferred tax asset has been recognized in respect of the income tax loss carryforwards of the acquired entity (refer to Note 1n and Note 9). On the other hand, a net deferred tax liability has been accounted for in the purchase price allocation for an amount of €2,405 million.

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The preliminary allocation of the purchase price is as follows:

(in millions of euros except useful lives expressed in number of years)	Lucent's carrying amount [1]	Fair value [2]	Useful lives
Cash and cash equivalents and marketable securities	2,814	2,814	-
Property, plant and equipment	920	1,180	1-40 years
Goodwill	389	-	
Acquired technologies	267	2,737	5-10 years
In process research & development	-	440	5-7 years
Customer relationships – long term	-	938	5-8 years
Customer relationships – short term (backlog)	-	197	13 months
Trade names	-	501	Indefinite
Inventories	636	1,060	(3)
Trade and other receivables	760	760	-
Payables and advanced billings	(1,082)	(1,071)	-
Pensions, retirement indemnities and other post-retirement benefits	114	(1,601)	-
Bonds and notes issued	(3,885)	(3,099)	-
Provisions	(950)	(951)	-
Deferred taxes	92	(2,405)	-
Deferred compensation (unvested outstanding stock options)	-	37	
Other assets and liabilities	141	303	-
NET ASSETS ACQUIRED	**216**	**1,840**	

(1) Amounts indicated are the carrying values under U.S. GAAP.
(2) Amounts indicated in this column include both purchase price allocation adjustments and conversion of Lucent's U.S. GAAP historical data to IFRS.
(3) Estimated liquidation period of the inventory step-up is 6 months.

Determination of the goodwill:

(in millions of euros)	Amount
Cost of the business combination (A)	9,891
Net assets acquired (B)	1,840
Goodwill (A) – (B)	**8,051**

The business acquired from Lucent contributed €278 million to net loss including adjustments subsequent to purchase accounting entries (such adjustments primarily include an amortization of intangible and tangible assets for an amount of €60 million before tax, the partial liquidation of the inventory step-up for €167 million before tax, the restructuring costs described in the following paragraph for an amount of €234 million before tax and a positive tax impact of €179 million) for the period from December 1, 2006 to December 31, 2006. If the acquisition had occurred on January 1, 2006, the Group's revenue would have been €18,254 million, the income (loss) from operating activities would have been a loss of €(988) million, the net loss would have been €(231) million, and the basic and diluted earning per share would have been €(0.12) including adjustments subsequent to purchase accounting entries (such adjustments primarily include amortization of intangible and tangible assets for an amount of €606 million before tax, the liquidation of the inventory step-up for an amount of €451 million before tax, the restructuring costs described in the following paragraph for an amount of €246 million before tax and a positive tax impact of €508 million).

Pursuant to the merger with Lucent and to the acquisition of Nortel Networks Corporation ("Nortel") UMTS radio access business (see description of the transaction below), certain of Lucent's product lines and businesses have been discontinued and the corresponding asset write-off, as well as the estimated associated costs (based upon current assumptions at the closing date of the balance sheet) to which the Group was committed at period end, have been recorded in restructuring costs at €234 million.

- During the second quarter 2006, Alcatel acquired privately-held VoiceGenie for €30 million in cash. Founded in 2000, VoiceGenie is a leader in voice self-service solutions, with a software platform based on Voice XML, an open standard used for developing self-service applications by both enterprises and carriers. The initial allocation of the cost of the business combination led to recognizing US$12 million of depreciable intangible assets and US$19 million of goodwill, with the net assets of this company amounting to US$7 million at the acquisition date (of which US$4 million of cash and cash equivalents). The contribution of this company to Alcatel-Lucent's 2006 results is not significant.

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- On April 5, 2006, Alcatel announced that the Board of Directors of Thales had approved the acquisition in principle of Alcatel–Lucent's satellite subsidiaries, its railway signaling business and its integration and services activities for mission–critical systems not dedicated to operators or suppliers of telecommunications services.

On December 4, 2006, Alcatel–Lucent and Thales announced that they had signed a final agreement. This agreement follows the signature of a new Space Alliance agreement between Thales, Alcatel–Lucent and Finmeccanica, in which Finmeccanica agreed to the transfer to Thales of Alcatel–Lucent's share in Alcatel Alenia Space and Telespazio.

The transaction primarily consisted of the contribution and disposal by Alcatel–Lucent to Thales of the following assets:

1. In the Space sector:

- Alcatel–Lucent's 67% stake in the capital of Alcatel Alenia Space (this joint venture company, created in 2005, is the result of combining Alcatel's and Finmeccanica's Space assets, the latter holding a 33% stake).
- Alcatel–Lucent's 33% share in the capital of Telespazio, worldwide leader in satellite services, of which 67% is held by Finmeccanica.

With respect to this contribution of the space activities, a cash payment of €670 million will be made to Alcatel–Lucent, subject to a reassessment by an independent expert at the beginning of 2009, which may trigger an upward value adjustment.

2. In the domain of critical systems for security:

The Transport Systems activities, a worldwide leader in signaling solutions for rail transport and urban metros.

Critical Systems Integration activities not dedicated to operators or suppliers of telecommunications services and covering mainly the transport and energy sectors.

On January 5, 2007, with respect to this transfer, 25 million new Thales shares will be issued in favor of Alcatel–Lucent, and Alcatel–Lucent will receive a cash payment of €40 million. As a result of the issuance of the shares, Alcatel–Lucent will increase its shareholdings to 20.95%, which will continue to account for as an investment in associates and the French State remains the main shareholder with a 27.29% stake (held directly or indirectly).

The transaction will be implemented in two phases, as, on November 28, 2006, the European Commission entered Phase II of the regulatory approval process for the transfer to Thales of Alcatel–Lucent's share in Alcatel Alenia Space and Telespazio because of competition concerns related to the position of Thales' Space Traveling Wave Tubes (TWT) business. This phase II is foreseen to last for a maximum of 90 working days. Thales first convened an extraordinary general Shareholders' Meeting on January 5, 2007, in order to approve the transfer of Alcatel–Lucent's transportation and security assets. Due to the competition concerns related to the transfer of the space activities, Thales will provide the Commission with clarifications and remedies in view of reaching a positive conclusion and a closing for the contribution of the space activities no later than April 2007.

The assets envisaged for the contribution and disposal have been accounted for as assets held for sale in the consolidated financial statements at December 31, 2006, as the criteria for classification in "assets held for sale" as defined by IFRS 5 "Non–current Assets Held for Sale and Discontinued Operations" were met at the balance sheet date and as some of the remaining uncertainties as of September 30, 2006 have now been cleared (i.e. signature of a final agreement between Alcatel–Lucent and Thales, receipt of Finmeccanica's waiver concerning the transfer of Spatial business assets, receipt of French State approval, etc.).

The assets contributed or disposed of to Thales have been considered as one single transaction and one disposal group of assets as defined by IFRS 5 based upon the following facts and circumstances:

- the transaction is a global transaction that has to be carried out in two phases with two closing dates due exclusively to the European Commission's authorization process concerning the Space business;
- the Space activities disposal is contingent on the assets contribution of Transport Systems and Critical Systems Integration; and
- the amount of €670 million concerning the disposal of the Space business is considered rather as a preliminary payment of the selling price (as an external expert will establish the definitive price in 2009) and is therefore not entirely representative of the market price of this business. It is one of the reasons why Alcatel–Lucent had no intention of disposing of the Space business without including it in the larger transaction defined in the Master Agreement.

As the fair value less costs to sell of this disposal group is higher than the carrying amount, such carrying amount has not been adjusted as of December 31, 2006. All net assets to be disposed of/contributed to Thales have been isolated on the two specific line items related to discontinued operations in the consolidated balance sheet (that is, "Assets held for sale" and "Liabilities related to disposal groups held for sale") as of December 31, 2006. The 2006 results of the disposal group is presented in the "Income (loss) from discontinued operations" line item in the consolidated income statement and the 2005 / 2004 consolidated income statements have been re–presented accordingly. Detailed impacts are presented in Note 10.

The capital gain related to this disposal and the difference between the preliminary selling price of the Space business (as described above) and its carrying value, will be accounted for during 2007, representing an estimated net positive impact on the net result before tax and any price adjustment of €0.8 billion.

- On September 1, 2006, Alcatel announced that it had signed a non–binding Memorandum of Understanding with Nortel to acquire its UMTS radio access business (UTRAN) and related assets for US$320 million.

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On December 4, 2006, Alcatel-Lucent announced that it had signed a final agreement with Nortel.

On December 31, 2006, Alcatel-Lucent completed the acquisition of Nortel's UMTS radio access business (UTRAN) and related assets.

Pursuant to the transaction, Alcatel-Lucent acquired Nortel's UMTS radio access technology and product portfolio, associated patents and tangible assets as well as customer contracts for US$320 million. Approximately 1,700 of the employees of Nortel's UMTS access business were transferred to Alcatel-Lucent.

The assets acquired from Nortel have been considered as a business as defined in IFRS 3 and the purchase price has been allocated as follows:

(in millions of euros)	**Amount**
Cost of the business combination (A):	
Gross consideration	250
Working capital credit and other price adjustments	(18)
Cost of the business combination to be allocated	**232**
Net assets acquired at fair value (B):	
• Fixed assets	38
• Inventories	15
• In process research and development	24
• Acquired technologies	103
• Customer relationships	41
• Other assets and liabilities	–
Net assets acquired	**221**
GOODWILL (A) – (B)	**11**

The above described allocation of the cost of the business combination is preliminary and could be amended in 2007.

The carrying value of the net assets acquired on Nortel's books is not known.

As the transaction was completed as of December 31, 2006, the contribution to the net result of this business was zero with the exception of the impacts described in the following section.

Nortel indicated that the 2006 UMTS Access («UA») revenues associated with the assets sold was approximately $660 million.

As the technologies acquired are duplicating some of the technologies that Alcatel has already developed and capitalized and some of Lucent's technologies corresponding to certain intangible assets that were fair valued in the purchase price accounting, an impairment loss was recorded, once the contemplated deal with Nortel and the merger with Lucent had estimated been completed and the decisions to keep or to abandon all or some of these technologies had been taken. The corresponding write-off and the estimated associated future costs for which Alcatel-Lucent was already committed at December 31, 2006 represented a total amount of €494 million that has been accounted for in «restructuring costs» in the income statement.

- During the third quarter 2006, Alcatel and Finmeccanica agreed upon the price adjustments to be made to the values assigned at the time of their contributions to Alcatel Alenia Space and to Telespazio. These adjustments resulted in a €37.5 million reduction in goodwill and in an increase in the gain on disposal of €15 million.

The main changes in consolidated companies for 2005 were as follows:

- On March 2, 2005, Alcatel announced the acquisition of 100% of Native Networks, a provider of carrier-class optical Ethernet transport solutions, for a purchase price of US$55 million. The purchase price was allocated US$20 million to depreciable intangible assets and US$38 million to goodwill (the net assets of this company being negative US$3 million at the acquisition date). The contribution from this company had no impact on Alcatel's 2005 income.
- On May 17, 2005, TCL Corp. and Alcatel announced the end of their handset partnership. Alcatel agreed to swap its 45% stake in the joint venture for TCL Communication Holdings Ltd shares (these shares are listed on the Hong Kong market).
- On July 1, 2005, Alcatel and Finmeccanica announced the successful creation of two joint ventures that had been described in a memorandum of understanding signed by the parties on June 24, 2004: Alcatel Alenia Space (Alcatel-Lucent holds 67% and Finmeccanica 33%) and Telespazio Holding (Finmeccanica holds 67% and Alcatel 33%). These joint ventures are consolidated using the proportionate consolidation method starting July 1, 2005.

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Alcatel analyzed this transaction as a sale to Finmeccanica of 33% of Alcatel Space's satellite industrial activity and 67% of its service activity and as an acquisition of 67% of Alenia Spazio (the industrial space systems of Finmeccanica) and of 33% of Telespazio (service activities for Finmeccanica's space systems).

The values assigned to this transaction were €1,530 million for Alenia Space and €215 million for Telespazio, resulting in a gain to Alcatel on the sale before tax of €129 million in 2005 and in goodwill not yet allocated of €143 million. Alcatel received from Finmeccanica an equalization payment of €109 million. Net cash resulting from the activities acquired and disposed of is €15 million at the transaction date. Due to the existence of price adjustment clauses in the agreement between Alcatel and Finmeccanica, adjustments to the above amounts were made during the third quarter 2006 (see above).

Proportionately consolidating the combined space activities of the two partners did not have a significant impact on Alcatel's revenues, operating margin and total balance sheet. However, this consolidation method resulted in recognizing a deferred tax charge of €38 million due to the removal from the French tax consolidation of the companies transferred to the joint ventures in the context of the transaction described above.

The main changes in consolidated companies for 2004 were as follows:

- On January 14, 2004, Alcatel, pursuant to its announcement in October 2003, finalized the sale of SAFT, a subsidiary of the Group that specialized in battery operations, to Doughty Hanson for €390 million. The gain on disposal amounted to €256 million and was recorded in 2004 under the caption "income (loss) from discontinued operations" (see Note 10).

- On April 26, 2004, Alcatel and TCL Communication Technology Holdings Limited announced the execution of a memorandum of understanding to form a joint venture mobile handset company. The joint venture company officially started operations on August 31, 2004 and was 55% owned by TCL and 45% owned by Alcatel. It was consolidated under the equity method in Alcatel's accounts from September 1, 2004. The mobile phone business had been accounted for as a discontinued operation as from January 1, 2004 (see Note 10). The gain on disposal was recorded in 2004 under the caption "income (loss) from discontinued operations" (see Note 10).

- On May 17, 2004, Alcatel announced that it had signed definitive binding documentation with Draka Holding N.V. ("Draka") in relation to the proposed combination of their respective global optical fiber and communication cable businesses. The final agreement was signed on July 2, 2004. Draka owns 50.1% and Alcatel owns 49.9% of the new company, Draka Comteq B.V. This company was consolidated under the equity method as of July 1, 2004. Alcatel's optical fiber activity has been accounted for as a discontinued operation as of and after January 1, 2004 (see Note 10). As the 2004 financial statements for Draka Comteq BV were not available at the closing date of Alcatel's financial statements, an estimated gain/loss on the sale and an estimated share in the net result of Draka Comteq BV were taken into account in the income statement at December 31, 2004. The definitive financial statements of Draka Comteq BV were received during the second quarter of 2005 and the gain/loss was adjusted accordingly. The amount of the loss recorded in 2004 and the positive adjustment that was recorded in 2005 is €(16) million and €8 million respectively.

- On June 18, 2004, Alcatel and Finmeccanica announced the execution of a memorandum of understanding to merge their space activities through the creation of two sister companies, to which both partners will contribute their respective satellite industrial and service activities.

The first company, Alcatel Alenia Space, of which Alcatel will hold 67% and Finmeccanica 33%, will combine Alcatel Space and Alenia Spazio's industrial activities. This company will concentrate on the design, development, and manufacture of space systems, satellites, equipment, instruments, payloads and associated ground systems. The management team of Alcatel Alenia Space will be located in France. The company will operate through five business divisions (Telecommunications, Optical Observation and Science, Observation Systems and Radar, Navigation, Infrastructure and Transportation).

The second company, of which Finmeccanica will hold 67% and Alcatel 33%, will combine Telespazio (Finmeccanica group) with Alcatel Space's operations and services activities. This company will concentrate on operations and services for satellite solutions, which includes control and exploitation of space systems as well as value-added services for networking, multimedia and earth observation. Its management team will be located in Italy.

The definitive agreement relating to the creation of these two new companies was signed on January 28, 2005, subject to the required approvals from the regulatory authorities, which were obtained in 2005.

- On September 17, 2004, Alcatel announced that it had acquired privately held, U.S.-based eDial Inc., a leading provider of conferencing and collaboration services for businesses and telephone companies. The purchase price was €22 million (based on the market value at that date of Alcatel's American Depositary Shares) and was paid for in Alcatel ADSs and in €3.4 million of cash. The goodwill acquired in this business combination is €16 million, after recognizing €8 million of depreciable intangible assets and €2 million of other net acquired liabilities (including approximately €1 million of cash). The contribution from this company had no impact on Alcatel's 2004 income.

- On September 17, 2004, Alcatel signed an agreement with a private equity firm, Ripplewood, to divest all of its electrical power system activities (Saft Power Systems). The closing of this sale took place on January 25, 2005. The results of this business were recorded as a discontinued operation in 2004 (see Note 10). The gain/loss on disposal of the shares was recorded in discontinued operations in the first six months of 2005.

- On December 14, 2004, Alcatel announced that it had sold 7.1 million Avanex shares, bringing the Group's stake in this company to below 20%. With this partial sale of its investment and in the absence of a seat on Avanex's Board of Directors, the Group considers that it no longer exercises significant influence on Avanex and, as a result, as from this date, the remaining net book value of the shares has been accounted for in other non-current financial assets and no longer in share in net assets of equity affiliates.

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- On December 16, 2004, Alcatel completed the acquisition of the privately held, U.S.-based Spatial Communications (known as Spatial Wireless), a leading provider of software-based and multi-standard distributed mobile switching solutions. All of Spatial Wireless shares were acquired for 17.4 million Alcatel's ADSs, representing a purchase price of €207 million. The total cost of this acquisition is €223 million, after recognizing costs of acquisition and the fair value of equity instruments granted to Spatial Wireless employees in return for services rendered. The goodwill acquired in this business combination is €175 million, after recognizing €62 million of depreciable intangible assets and €14 million of other net acquired liabilities (including approximately €2 million of cash). The contribution from this company had no impact on Alcatel's 2004 income.

The financial impacts of other business combinations not referred to above are insignificant, either individually or in the aggregate.

Note 4 – Information by business segment and by geographical segment

The tables below present information for the business segments described hereunder. They take into account the organization put into place after the completion of Alcatel and Lucent merger at the end of 2006 and comprise three business segments addressing three principal markets.

The overall business is divided into three Business Segments addressing carrier, services and enterprise markets and a decentralized regional organization consisting of four geographic regions.

The first Business Segment is Carrier and is composed of three Business Groups: the Wireless Business Group, the Wireline Business Group, and the Convergence Business Group, addressing the needs of the carrier market.

- The Wireless Business Group provides products and applications software for end-to-end solutions in the wireless arena and has five business divisions spanning all wireless technologies: GSM/WiMAX, WCDMA, CDMA/EVDO, Wireless Transmission (also known as microwave) and Radio Frequency Systems. The scope of the business divisions includes product and network strategy, product development, product and project management, product marketing, demand planning, sales support and contract execution.
- The Wireline Business Group provides IP network solutions that allow service providers, enterprises and governments worldwide to deliver voice, data and video communication services to end-users. It has three business divisions, aligned with key market segments – Access, IP and Optics – each with global responsibility for capitalizing on specific market dynamics through portfolio, product and solution planning. Each division is responsible for product and network strategy, product development, product marketing, demand planning, sales support and contract execution.
- The Convergence Business Group addresses the emergence of a significant transformation of network technologies, applications and services – one that is projected to enable converged services across service-provider networks, enterprise networks and an array of personal devices. It has three business divisions: IMS applications and services, Multimedia and Payment and Multicore.

As a result of the increasing trend within the telecommunication industry of converging wireline, wireless services and products provided to clients, Alcatel-Lucent is assessing the performance of Carrier Business Groups as a whole in terms of risk profile and long-term profitability.

The second Business Segment is Services and comprises one Business Group: the Services Business group, which provides a broad and comprehensive set of professional services that encompass the entire network lifecycle – Consult & Design, Integrate & Deploy, as well as Maintain & Operate. It includes services such as planning and executing IP transformation, integrating application platforms such as IP Multimedia Subsystem (IMS) & Service Delivery Environment, reengineering Operations Support Systems (OSS) / Business Support Systems (BSS) operational processes and strengthening network security. It has five business divisions: Network integration, Professional services, Network operations, Maintenance and Enterprise/Government services.

The third Business Segment is Enterprise and comprises one Business Group: the Enterprise Business Group, which delivers secure, end-to-end, business-critical communications solutions that enable new business generation for governments and enterprises. It includes unified communications and contact centers, IP telephony, IP address and performance management software and security solutions. It has three Business Divisions: Enterprise Solutions, Genesys (contact center applications) and Industrial Components.

The segment Other includes miscellaneous service businesses or non-core businesses, such as corporate purchasing, reinsurance and banking activities and corporate holding companies accounting mainly for corporate expenses. None of these activities are sufficiently significant to be disclosed as reportable segments.

The information by segment follows the same accounting policies as those used and described in these consolidated financial statements.

All inter-segment commercial relations are conducted on an arm's length basis on terms and conditions identical to those prevailing for the supply of goods and services to third parties.

The performance measure of each business segment is based on the "Income (loss) from operating activities before restructuring costs, impairment of intangible assets and gain/(loss) on disposal of consolidated entities".

The business segments presented are identical to those appearing in the information given to the Management Committee.

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Segment information for the prior periods have been re-presented to conform to the current period presentation, to reflect the organization put in place at the closing date of the merger and the disposal and discontinuation of significant businesses described in Note 3 (that is, assets disposed of or contributed to Thales).

(a) Information by business segment

2006 *(in millions of euros)*	Carrier	Enterprise	Services	Other	Total Group
2006					
Total – Revenues	8,989	1,420	1,721	152	12,282
Of which:					
Wireline	*4,463*	–	–	–	–
Wireless	*3,049*	–	–	–	–
Convergence	*1,477*	–	–	–	–
Income (loss) from operating activities before restructuring costs, impairment of intangible assets and gain/(loss) on disposal of consolidated entities	**393**	**109**	**195**	**(3)**	**694**
Restructuring costs	(631)	2	(1)	(77)	(707)
Impairment of capitalized development costs	(141)	–	–	–	(141)
Gain/(loss) on disposal of consolidated entities	–	–	–	15	15
Income (loss) from operating activities	**(379)**	**111**	**194**	**(65)**	**(139)**
Depreciation and amortization (tangible and intangible assets)	411	84	37	99	631
Share in net income (losses) of equity affiliates	–	–	–	22	22
Capital expenditures (tangible and intangible assets)	473	84	29	98	684
Shares in equity affiliates	–	–	–	682	682
Segment assets (assets included in operating working capital) (1)	9,521	483	2,113	1,872	13,989
Segment liabilities (liabilities included in operating working capital) (2)	(3,778)	(301)	(1,097)	(294)	(5,470)

(1) Segment assets represent intangible assets and property plant and equipment. Assets included in operating working capital comprise inventories and work in progress and customer receivables (including those recorded in amounts due from / to customers on construction contracts) and advances and progress payments. These captions are presented in Note 18.

(2) Segment liabilities represent liabilities included in operating working capital that comprise trade payables and related accounts, customers' deposits and advances and provisions for product sales (including those provisions recorded in amounts due from / to customers on construction contracts). These captions are presented in Notes 18 and 27.

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2005 *(in millions of euros)*	Carrier	Enterprise	Services	Other	Total Group
Total – Revenues	**8,463**	**1,248**	**1,378**	**130**	**11,219**
Of which:					
Wireline	*3,876*	-	-	-	-
Wireless	*2,806*	-	-	-	-
Convergence	*1,781*	-	-	-	-
Income (loss) from operating activities before restructuring costs, impairment of intangible assets and gain/(loss) on disposal of consolidated entities	**778**	**111**	**212**	**(80)**	**1,021**
Restructuring costs	(4)	(6)	(4)	(65)	(79)
Impairment of capitalized development costs	-	-	-	-	-
Gain/(loss) on disposal of consolidated entities	-	-	-	129	129
Income (loss) from operating activities	**774**	**105**	**208**	**(16)**	**1,071**
Depreciation and amortization (tangible and intangible assets)	351	81	37	51	520
Share in net income (losses) of equity affiliates	-	-	-	(14)	(14)
Capital expenditures (tangible and intangible assets)	407	80	45	61	593
Shares in equity affiliates	-	-	-	606	606
Segment assets (assets included in operating working capital) [(1)]	2,026	486	820	4,516	7,848
Segment liabilities (liabilities included in operating working capital) [(2)]	(3,096)	(284)	(756)	(1,517)	(5,653)

(1) Segment assets represent intangible assets and property plant and equipment. Assets included in operating working capital comprise inventories and work in progress and customer receivables (including those recorded in amounts due from / to customers on construction contracts) and advances and progress payments. These captions are presented in Note 18.
(2) Segment liabilities represent liabilities included in operating working capital that comprise trade payables and related accounts, customers' deposits and advances and provisions for product sales (including those provisions recorded in amounts due from / to customers on construction contracts). These captions are presented in Notes 18 and 27.

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2004 *(in millions of euros)*	Carrier	Enterprise	Services	Other	Total Group
Total – Revenues	**7,573**	**1,211**	**1,266**	**213**	**10,263**
Of which:					
Wireline	*3,538*	–	–	–	–
Wireless	*2,297*	–	–	–	–
Convergence	*1,738*	–	–	–	–
Income (loss) from operating activities before restructuring costs, impairment of intangible assets and gain/(loss) on disposal of consolidated entities	**699**	**120**	**181**	**3**	**1,003**
Restructuring costs	(136)	(8)	(19)	(150)	(313)
Impairment of capitalized development costs	(88)	–	–	–	(88)
Gain/(loss) on disposal of consolidated entities	–	–	–	–	
Income (loss) from operating activities	**475**	**112**	**162**	**(147)**	**602**
Depreciation and amortization (tangible and intangible assets)	292	74	37	84	487
Share in net income (losses) of equity affiliates	–	–	–	(61)	(61)
Capital expenditures (tangible and intangible assets)	348	75	39	66	528
Shares in equity affiliates	–	–	–	604	604
Segment assets (assets included in operating working capital) [1]	3,957	454	734	1,579	6,724
Segment liabilities (liabilities included in operating working capital) [2]	(2,673)	(282)	(735)	(1,568)	(5,258)

(1) Segment assets represent intangible assets and property plant and equipment. Assets included in operating working capital comprise inventories and work in progress and customer receivables (including those recorded in amounts due from / to customers on construction contracts) and advances and progress payments. These captions are presented in Note 18.

(2) Segment liabilities represent liabilities included in operating working capital that comprise trade payables and related accounts, customers' deposits and advances and provisions for product sales (including those provisions recorded in amounts due from / to customers on construction contracts). These captions are presented in Notes 18 and 27.

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(b) Information by geographical segment

(in millions of euros)	France	Other Western Europe	Rest of Europe	Asia Pacific	U.S.A.	Other Americas	Rest of world	Consolidated
2006								
Revenues								
• by geographical market	1,110	2,874	883	2,116	2,323	1,113	1,863	12,282
Other information by geographical segment								
Segment assets (1)	2,522	2,084	171	1,460	6,997	543	212	13,989
Capital expenditures (tangible and intangible assets)	286	143	11	77	115	38	14	684
2005								
Revenues								
• by geographical market	1,341	2,657	929	1,779	1,572	978	1,963	11,219
Other information by geographical segment								
Segment assets (1)	3,248	1,852	140	1,071	647	652	238	7,848
Capital expenditures (tangible and intangible assets)	263	91	8	80	111	31	9	593
2004								
Revenues								
• by geographical market	1,149	2,598	828	1,728	1,422	933	1,605	10,263
Other information by geographical segment								
Segment assets (1)	3,027	1,641	137	841	455	467	156	6,724
Capital expenditures (tangible and intangible assets)	259	89	6	63	96	12	3	528

(1) Segment assets represent intangible assets and property plant and equipment. Assets included in operating working capital comprise inventories and work in progress and customer receivables (including those recorded in amounts due from / to customers on construction contracts) and advances and progress payments. These captions are presented in Note 18. Intangible assets included in the purchase price adjustments of Lucent have not been allocated to regions at this stage. They are presented in the USA The allocation will be completed in 2007.

Note 5 – Revenues

(in millions of euros)	2006	2005	2004
Product sales (construction contracts)	1,566	1,620	1,333
Other equipment sales	8,878	8,120	7,540
Service revenues	1,721	1,378	1,266
License revenues	40	36	67
Rental income and other revenues	77	65	57
TOTAL	**12,282**	**11,219**	**10,263**

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Note 6 – Research and development costs

(in millions of euros)	2006	2005	2004
Research costs	61	54	83
Development costs	1,405	1,244	1,237
Research and development costs, net	**1,466**	**1,298**	**1,320**
As a percentage of revenues	*11.9%*	*11.6%*	*12.9%*
Customer design engineering costs	152	129	91
Capitalized development costs	109	107	130
Research and development effort	**1,727**	**1,534**	**1,541**
As a percentage of revenues	*14.1%*	*13.7%*	*15.0%*

In accordance with IFRSs, development costs meeting certain criteria described in Note 1f are capitalized.

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Note 7 – Impairment losses on assets recognized in the income statement

(in millions of euros)	Carrier	Enterprises	Services	Other	Eliminations	Total Group
2006						
Impairment losses for goodwill	-	-	-	-	-	-
Impairment losses for capitalized development costs [1]	(104)	-	-	-	-	(104)
Impairment losses for other intangible assets [1]	(40)	-	-	-	-	(40)
Impairment losses for property, plant and equipment	(2)	-	-	-	-	(2)
Impairment losses for shares in equity affiliates	-	-	-	(8)	-	(8)
Impairment losses for financial assets	(1)	-	-	(3)	-	(4)
Total – net	**(147)**	**-**	**-**	**(11)**	**-**	**(158)**
of which reversal of impairment loss [2]	*2*	-	-	*1*	-	*3*
2005						
Impairment losses for goodwill	-	-	-	-	-	-
Impairment losses for capitalized development costs [1]	-	-	-	-	-	-
Impairment losses for other intangible assets [1]	(3)	-	-	-	-	(3)
Impairment losses for property, plant and equipment	-	-	-	-	-	-
Impairment losses for shares in equity affiliates	-	-	-	-	-	-
Impairment losses for financial assets	1	(1)	-	(17)	-	(17)
Total – net	**(2)**	**(1)**	**-**	**(17)**	**-**	**(20)**
of which reversal of impairment loss [2]	*17*	-	-	*17*	-	*34*
2004						
Impairment losses for goodwill	-	-	-	-	-	-
Impairment losses for capitalized development costs [1]	(88)	-	-	-	-	(88)
Impairment losses for other intangible assets [3]	(18)	-	-	-	-	(18)
Impairment losses for property, plant and equipment	(1)	-	-	(9)	-	(10)
Impairment losses for shares in equity affiliates	-	-	-	(30)	-	(30)
Impairment losses for financial assets	73	-	-	(26)	-	47
Total – net	**(34)**	**-**	**-**	**(65)**	**-**	**(99)**
of which reversal of impairment loss [2]	*73*	-	-	*7*	-	*80*

(1) Of which €141 million is included in the income statement under "impairment of intangible assets".
(2) Recorded in income statement caption "Other financial income (loss)".
(3) Recorded in income statement caption "Impairment of intangible assets".

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Note 8 – Financial income (loss)

(in millions of euros)	Q4 2006	2006	2005 represented (1)	2005 published excluding discontinued activities	2004 represented (1)	2004 published excluding discontinued activities
Finance costs	**(33)**	**(98)**	**(93)**	**(93)**	**(108)**	**(108)**
Dividends	1	8	4	4	5	5
Provisions for financial risks	–	–	–	–	2	2
Impairment losses on financial assets (2)	(5)	(4)	(17)	(17)	47	47
Net exchange gain (loss)	(8)	(29)	(18)	(18)	(20)	(20)
Financial component of pension costs	(11)	(47)	(44)	(44)	(48)	(48)
Actual and potential capital gain/(loss) on financial assets (shares of equity affiliates or non-consolidated securities and financial receivables) and marketable securities (3)	3	21	119	137	32	34
Other (4)	(37)	(61)	(19)	(19)	12	12
Other financial income (loss)	**(57)**	**(112)**	**25**	**43**	**30**	**32**
Total financial income (loss)	**(90)**	**(210)**	**(68)**	**(50)**	**(78)**	**(76)**

(1) As indicated in Note 1u, certain marketable securities previously included in the category of financial assets at fair value through profit or loss are now designated as financial assets available for sale, further to the "Fair Value Option" amendment to IAS 39 "Financial Instruments: Recognition and Measurement". The impact of this change on other financial income (loss), had it been applied in 2005 and 2004, is presented in the above represented column.

(2) Impairment loss of €23 million on the Avanex shares recorded in the first quarter of 2005 due to an unfavorable change in market price.

(3) Net gain on disposal of Nexans shares for €69 million during the first quarter of 2005 and net gain on disposal of Mobilrom shares for €45 million during the second quarter of 2005.

(4) Of which a loss of €18 million related to the adjustment of the conversion ratio of Lucent's series A and B convertible debentures (refer to Note 24c) in the fourth quarter of 2006. Of which €15 million relates to interest charge recorded in other financial loss in the third quarter 2006, which is due to a late payment of a debt relating to a tax dispute.

Note 9 – Income tax and related reduction of goodwill

(a) Analysis of income tax (charge) benefit and related reduction of goodwill

(in millions of euros)	Q4 2006	2006	2005	2004
Reduction of goodwill related to realized income tax loss carry forwards (1)	(5)	(5)	–	–
Current income tax (charge) benefit	(14)	(71)	(48)	83
Deferred income tax (charge) benefit, net (2)	116	113	(98)	(117)
INCOME TAX (CHARGE) BENEFIT AND RELATED REDUCTION OF GOODWILL	**97**	**37**	**(146)**	**(34)**

(1) If the potential benefit of Lucent's income tax loss carry forwards or other deferred tax assets does not satisfy the criteria for separate recognition, as defined in IFRS 3, when a business combination was initially accounted for but such benefits are subsequently realized, Alcatel-Lucent will recognize the resulting deferred tax income in profit or loss and in addition, reduce the carrying amount of goodwill (as an expense) to the amount that would have been recognized if the deferred tax asset had been recognized as an identifiable asset from the merger date.

(2) Of which €175 million in Q4-2006 related to the reversal of deferred tax liabilities accounted for in the purchase price allocation of Lucent as described in Note 3.

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(b) Effective income tax rate

The effective tax rate can be analyzed as follows:

(in millions of euros)	2006	2005	2004
Income (loss) before tax, related reduction of goodwill and discontinued operations	(327)	1,007	465
Average income tax rate	41.2%	31.7%	24.3%
Expected tax (charge) benefit	137	(319)	(113)
Impact on tax (charge) benefit of:			
• reduced taxation of certain revenues	5	–	–
• utilization of previously unrecognized tax losses and other permanent difference	140	165	42
• adjustment to prior years' current tax charge	(1)	12	1
• recognition of previously unrecognized deferred tax assets	103	171	15
• deferred tax assets no longer recognized	(78)	(151)	(33)
• non recognition of tax losses	(272)	(24)	(62)
• effect of tax rate changes	(3)	(5)	(20)
• tax credits	16	5	12
• other permanent differences	(5)	–	124
Actual income tax (charge) benefit	42	(146)	(34)
Effective tax rate	12.84%	14.50%	7.31%

Average income tax rate is the sum of income (loss) before taxes of each subsidiary, multiplied by the local statutory rate for each subsidiary, divided by consolidated income (loss) before taxes from continuing operations.

Changes in the average income tax rate from 2004 to 2006 are due to differences in the contribution of each tax entity to income (loss) before tax and to the fact that some units have a positive contribution and others have a negative one.

In 2004, the "other" line comprised significant releases of tax contingencies.

(c) Deferred tax balances

Balances *(in millions of euros)*	2006	2005	2004
Deferred tax assets			
• deferred tax assets recognizable	12,716	7,042	6,105
• of which not recognized	(11,024)	(5,274)	(4,467)
Net deferred tax assets recognized	1,692	1,768	1,638
Net deferred tax (liabilities)	(2,524)	(162)	(132)
Net deferred tax assets (liabilities)	(832)	1,606	1,506